SYNSTRAT

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Vision Group Holdings Ltd Troubles – Lessons for Dental Corporates

A recent report in the Australian Financial Review indicated that the CEO of ophthalmology services provider Vision Group Holdings, Geoff Thompson, had said that the company is making headway with its plan to sell either all or part of its business as it attempts to stem the departure of doctors through the implementation of its new remuneration model.

Vision Group shares traded at a high of over $5 several years ago, but have since struggled and are now trading at 27.5 cents. The stock market has been concerned about the impact of the increased doctors' pay on its margins in the 2011 financial year. Obviously the market does not believe that it will be able to achieve a significant sale price. Analysts are concerned that the lower profit outlined will reduce Vision's ability to repay debt. The lending limits of Vision's two year debt facility commenced in August 2009 with Westpac Banking Corporation and the ANZ Bank have been wound back from $120 million to $110 million, with a further reduction to $100 million in 2011. Vision Group has suspended dividend payments until that facility expires next year. It posted a net loss of $58.4 million for the year ended 30 June 2010. It is likely that its attempt to sell the business is being forced upon it by its need to eventually repay the bank debt.

Vision Group has written off $66 million of goodwill following impairment testing. Its revenue was down 5% resulting from clinic closures and departure of doctors. Its banks have forced it to pay an increased margin over its borrowings. The current rate is a margin of 4.6% above bank bills. The banks have also forced Vision to suspend its dividends.

Vision Group is currently in litigation with two doctors.

Its new remuneration model forced on it by doctors is based on the doctors receiving 65% of personal exertion EBIT. It has also made a long service leave provision.

The Lesson for Dental Corporates

The Vision Group experience indicates that corporates which borrow heavily and pay dearly for expensive dental practices, thereby taking a huge amount of goodwill onto their balance sheet, face possible future risks of:

1. Vendor dentists departing to practice elsewhere at the expiry of contracts.
2. The possibility of being forced to take very large write-offs of goodwill from the balance sheet under accounting impairment provisions.
3. The possibility that events 1 and 2 above will trigger a revision of bank lending requirements, leading to higher interest rates, forced debt reduction and suspension of dividend payments.

Our Overall Assessment
Personally I would not consider buying Vision Group Ltd shares, nor would I consider buying shares in a dental corporate with high bank borrowings matched by a near equal amount of goodwill on its balance sheet, if indeed a corporate with these impediments comes to market via IPO and listing.

Advice to Vendor Dentists
Ensure that the consideration you receive for your practice in cash payment upfront is sufficient to compensate you for the sale of your practice and the reduction of income while you work out your vendor terms contract.

General Advice
Any investor approached to take shares in a dental IPO needs to check carefully the list of vendor dentists and the time that each vendor dentist has to the expiry of their contracts. This information needs to be matched with the fees generated in their personal surgery. You must be able to assess the impact and probability of the loss of successful dentists and their possible replacement with dentists of much less experience and fee generating capacity.

Synstrat observes that some dentists have very high fee income generating capacity (some of the profession's leaders having fees well into seven figures generated in their personal surgery). However this is far above the capacity of the average dentist, who more typically generates around $400,000 of fees per annum.

Investors will need to assess the risk of vendor dentists demanding that they be paid a significantly higher percentage of their personal exertion EBIT as an inducement to keep them employed once their initial practice vendor contracts with the corporate end. This has the potential to substantially reduce profit available for payment of dividends to shareholders.

Due Diligence
It is essential that any vendor dentist considering taking share scrip as part payment for their practice be fully informed of the value of the goodwill on the corporate's balance sheet at the date of their transaction as compared to the close of a previous financial year, and the extent of bank financing and the conditions attached to that bank financing. This requires explicit knowledge of the bank covenants and the conditions under which the bank/banking syndicate who are lending to the corporate can increase interest rates, enforce a cessation of dividend payments or require a more rapid debt reduction. They will also need to consider that it is unlikely that individual dental practices can be resold by the corporate to dentists at the value paid for them by the corporate.

Lessons from Elsewhere
There are many lessons from previous corporatisation of professional practices. Refer to *Practice Corporatisation – Stockford Disease* on www.synstrat.com.au

In this sense the state of Vision Group Holdings Ltd may be regarded as the canary in the cage, warning investors to take heed of the risks involved when investing in the IPOs of health industry professional service companies.

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